

# Investment Management Industry Update

## Section 3855

### Fair valuation of securities traded in foreign markets

#### Background

Over the past several years, a number of North American investment funds have implemented fair valuation techniques for securities that trade in foreign markets. Foreign markets, particularly those in Asia, generally close before the opening of the North American markets. Many fund managers believe there is a strong correlation between the North American and foreign markets, particularly for foreign securities that are offered in ADR or similar form in North America. For example, a security may close at \$10 in the local market, then open the next day in that same local market at \$9 due to events unfolding in the North American Markets after the closure of the local Asian market. The fair valuation models employed by many fund companies amend the closing value reported in the local market based on various algorithms. These algorithms take into account the impact of observed market activity occurring after the local markets have closed but before the fund finalizes its valuation for the day.

CICA Handbook Section 3855 “Financial Instruments—Recognition and Measurement” (Section 3855) took effect for years commencing on or after October 1, 2006. This new standard provides specific guidance on valuation methods that should be used in preparing financial statements.

The question many fund managers are asking is whether the practice of applying fair valuation techniques in the circumstances described above complies with the recommendations of Section 3855.

#### Fair Valuation Concepts

The overarching principle outlined in Section 3855 is that the fair value of a security is the price that would be agreed upon by a willing buyer and a willing seller in an arm’s length transaction. For a security traded in an active market, Section 3855 states that this is best reflected by published market quotations and for securities not traded in an active market, by the use of an appropriate fair valuation technique. The principle further provides that any fair valuation technique makes maximum use of inputs observed in the markets. Section 3855 also states: “An equity instrument has

a quoted market price in an active market when quoted prices reflecting normal market transactions are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm’s length basis (see paragraph 3855.A44). Restricted stock is not considered to be quoted in an active market.”

Applying Section 3855 to securities traded in an active market follows the hierarchy below:

- 1) Use current bid price for long positions and current ask for short positions.
- 2) If current bid and ask prices are unavailable, use last transaction price provided that the economic circumstances have not changed significantly from the time of the last transaction.
- 3) Where the prices arrived under points 1 and 2 are proven not to be indicative of fair value, by the use of fair valuation techniques.

For securities that are not traded in an active market, Section 3855 states that a valuation technique should be employed, which may include reference to the fair value of substantially similar securities or by using discounted cash flow or option pricing model techniques.

#### PricewaterhouseCoopers Comment

Investment funds generally value their securities on a regular basis, often daily. Therefore, the importance of applying robust and consistent valuation techniques is of great importance to their ongoing business operations. In practice, funds typically subscribe to services that provide daily market price data. Some also subscribe to services that provide fair valuation factors to adjust the published market prices of international securities when they believe such adjustment is warranted by movements in the North American markets.

We believe that the hierarchy described above must be applied in preparing fund financial statements in accordance with GAAP.

When a fund can **clearly demonstrate** that activity occurring following the closure of the foreign markets but before the end of the fund's business day warrants using a price other than the published market prices of the local market, then it would be acceptable under Section 3855 to consider that activity in preparing the fund's financial statements.

We believe that the use of the above-discussed fair valuation techniques for international securities is an acceptable practice for investment funds only when the fund has a documented and robust policy on their use. This policy must define the criteria for valuing the security at a price other than the bid and ask prices in the local market. The policy must also set out the parameters to be used in establishing a fair value for the securities and such parameters must be referenced to **observed market data**, such as pricing of comparable securities observed in the North American markets following closure of the foreign markets, and be applied consistently. Moving away from bid and ask prices for securities traded in an active market cannot be based on subjective considerations, such as a portfolio manager's view of intrinsic value of a security.

The fund should also regularly assess the impact that events occurring in the North American markets have on the published market prices of securities traded in foreign markets as further

support for the continued use of fair valuation techniques. The standards require that a fund **disclose** the use of such fair valuation techniques and the basis of their application.

**In short, the policy must be comprehensive, based on observed market data and be rigorously applied. The policy must be disclosed in the fund's financial statements.**

## Finding the Right Approach

We neither specifically endorse the use of fair valuation techniques for securities traded in a foreign market, nor do we make any recommendations on the models funds should use to implement a policy of fair valuing such securities. **Each fund's circumstances must be carefully evaluated to assess the appropriateness of applying such policies.**

You should also be aware that the comments contained in this Update consider only currently published Canadian GAAP. Future changes in GAAP (in Canada as well as in US and International Financial Reporting Standards) and with securities regulation impacting funds have not been considered.

The professionals in our Investment Funds practice can help you evaluate your fund's circumstances and policies. Obtaining the perspective of a knowledgeable and objective third-party advisor will help you in achieving your objectives of fairness to your investors and in your financial statement presentation.

## For More Information

If you would like to find out more about our Investment Funds practice or how we can help you, contact one of the professionals listed below.

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